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DEPARTMENT OF TAXATION
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December 11, 2009

LETTER RULING NO. 2009-10

[redacted text]

Re: Application of certain tax incentives regarding [redacted text]

Dear [redacted text]:

This letter responds to your request of [redacted text] for a comfort ruling confirming that certain tax incentives are available if [redacted text] (the "Company") meets the definition of a qualified high technology business ("QHTB").

In general, Hawaii offers the following tax incentives to qualifying businesses:

1. The high technology business investment tax credit under § 235-110.9, Hawaii Revised Statutes ("HRS");
2. The income tax exclusion for royalties and other income derived from patents and copyrights received by an individual or a QHTB and developed and arising out of a QHTB under § 235-7.3, HRS;
3. The income tax exclusion for stock options, dividends from stock, the receipt of the options, the exercise of the options, and income from the sale of the options under § 235-9.5, HRS; and
4. The tax credit for research activities under § 235-110.91, HRS.

In addition, other tax provisions may provide tax incentives to a QHTB that do not depend on whether the business meets the definition of a qualified high technology business.

SHORT ANSWER

Based on the information in your request for a high tech comfort ruling, the questionnaire, "Does a Company Qualify for Hawaii Tax Incentives?" ("Questionnaire"), and the representations made by the Company as stated below in this letter (the "Representations"), the Company will meet the definition of a qualified high technology business as defined in both § 235-7.3, HRS and § 235-110.9, HRS, provided the amount of cash invested in the Company does not exceed \$500,000.

Letter Ruling No. 2009-10

[redacted text]

December 11, 2009

Page 2

Based solely on the Representations, the Company qualifies as a QHTB for purposes of the tax benefits identified above in Paragraph 1.

Based solely on the Representations, the patents, copyrights, or trade secrets developed and arising out of the Company will qualify for the tax benefits identified above in Paragraph 2.

Based solely on the Representations, the Company's members will qualify for the tax benefits identified above in Paragraph 3, as further discussed in Part III of this letter.

The Company is not requesting confirmation at this time as to whether its activities qualify for the tax benefits identified above in Paragraph 4.

FACTS REPRESENTED BY THE COMPANY

The Company makes the following representations:

A. COMPANY AND INVENTOR BACKGROUND

The Company is a Hawaii limited liability company (which may convert into a Delaware limited liability company). The Company did not make the election to be taxed as a corporation for income tax purposes. The Company is engaged in the business of researching, developing, and commercializing an invention that [redacted text] which results in positive biological effects on the human body such as [redacted text] (“[redacted text] System”).

The founder and inventor of the [redacted text] System is [redacted text]. [redacted text] has filed United States and international technical patent applications for the [redacted text] System, a copy of which is attached as Exhibit B. [redacted text] assigned his patent application and all rights to the [redacted text] System to the Company.

B. DESCRIPTION OF INVENTION

[redacted text]

C. RESEARCH AND DEVELOPMENT ACTIVITIES

The Company is seeking equity financing to continue its research and development of the [redacted text] System to improve the technology [redacted text].

The Company represents that its ultimate product/technology will be a device/apparatus that requires the Company to undertake substantial biological research in connection with the development of its technology, and knowledge gained from such research adds to the fundamental knowledge regarding the function of biological systems.

[redacted text]. Further, the Company plans to seek Food and Drug Administration (FDA) approval and begin clinical trials for the medical application of the [redacted text]

Letter Ruling No. 2009-10

[redacted text]

December 11, 2009

Page 3

System. The Company intends to license the [redacted text] System patent to affiliates and third parties located worldwide for commercialization.

The Company is seeking up to \$500,000 of cash investments from Hawaii investors. Investors may invest through a holding company that will be taxed as a partnership for federal and Hawaii income tax purposes (“Holding Company”). The Company will be treated as a separate entity from the Holding Company for purposes of §235-110.9, HRS and the other tax incentives described in this comfort ruling letter.

The Company has made additional representations in Exhibit A regarding jobs, Hawaii costs, tax incentives that may be claimed by the Company or its investors, long term business plans and investments.

LAW AND ANALYSIS

The requirements for these tax incentives and their application to the Company and related taxpayers are discussed below.

I. High technology business investment tax credit

For investments made in taxable years beginning after December 31, 2000, but before taxable years beginning after December 31, 2010, a nonrefundable high technology business investment tax credit of up to \$2,000,000 per taxpayer is available. The credit is graduated over five years (35% to 10%) from the date of the “investment”¹ in a QHTB. The credit is capped at varying amounts (\$700,000 in the year the investment is made to \$200,000 in the last year).

According to Act 178 (Session Laws of Hawaii, 2009), credits generated by investments received on or after May 1, 2009 and on or before December 31, 2010 are subject to additional restrictions. These include:

- Not more than 80% of a taxpayer's tax liability may be offset by utilizing such credits for tax years ending on or before December 31, 2010;

¹ “Investment” is defined as “a nonrefundable investment, at risk, as that term is used in section 465 (with respect to deductions limited to amount at risk) of the Internal Revenue Code, in a qualified high technology business, of cash that is transferred to the qualified high technology business, the transfer of which is in connection with a transaction in exchange for stock, interests in partnerships, joint ventures, or other entities, licenses (exclusive or nonexclusive), rights to use technology, marketing rights, warrants, options, or any items similar to those included in this definition, including but not limited to options or rights to acquire any of the items included in this definition. The nonrefundable investment is entirely at risk of loss where repayment depends upon the success of the qualified high technology business. If the money invested is to be repaid to the taxpayer, no repayment except for dividends or interest shall be made for at least one year from the date the investment is made. The annual amount of any dividend and interest payment to the taxpayer shall not exceed twelve per cent of the amount of the investment.” See § 235-1, HRS.

Letter Ruling No. 2009-10

[redacted text]

December 11, 2009

Page 4

- The credit must be taken ratably over the five year period in accordance with §235-110.9(a), HRS and may not exceed an investment tax credit allocation ratio of 1:1; and
- No carryover of any unused credits from investments made on or after May 1, 2009 for tax years ending on or before December 31, 2010.

Some of the credit claimed will be recaptured from the investor if at the close of any taxable year in the five-year period: (1) the Company no longer qualifies as a QHTB, (2) the Company or an interest in the Company is sold by the taxpayer investing in the QHTB, or (3) the taxpayer withdraws the taxpayer's investment wholly or partially from the QHTB.

The recapture will be equal to ten percent of the amount of the total tax credit claimed for the investment in the two taxable years prior to the year in which any of the aforementioned events occurs. The recaptured amount must be added to the investor's tax liability for the taxable year in which the recapture occurs.

If a QHTB accepts any investments after June 30, 2007, the QHTB is required to file an annual survey as described in Act 206 (Session Laws of Hawaii, 2007). Failure to file the survey when due may result in a penalty of \$1,000 per month for each month the annual survey is not filed, not to exceed a total of \$6,000 for any annual survey not filed. Furthermore, by accepting an investment for which an investment credit allowed under section 235-110.9, HRS may be claimed, the QHTB is deemed by statute to have consented to the public disclosure of the Company's name and status as a beneficiary of the investment credit.

To be considered a QHTB for purposes of this tax credit, in each of the years for which the credit will be claimed, the Company must employ or own capital or property, or maintain an office, in Hawaii and:

- (1) More than 50% of its total business activities must be qualified research and more than 75% of its qualified research must be conducted in Hawaii (the "Activity Test"); or
- (2) More than 75% of its gross income must be derived from qualified research and the income from this qualified research must be received from:
 - (a) Products sold from, manufactured in, or produced in Hawaii; or
 - (b) Services performed in Hawaii (the "Gross Income Test").²

² This definition of a QHTB for purposes of § 235-110.9 differs from the definition of a QHTB in § 235-7.3, HRS, which is discussed in Part II of this letter.

Letter Ruling No. 2009-10

[redacted text]

December 11, 2009

Page 5

If the Company contracts with another person to perform qualified research, the research will qualify as research performed by the Company for the purpose of determining the Company's status as a QHTB only if the contract meets the following requirements:

- (1) The contract must be entered into before the performance of the qualified research activity;
- (2) The contract requires the Company to bear the expense of the research even if the project is unsuccessful; and
- (3) The contract provides that the research is to be performed on behalf of the Company and the Company will have substantial rights to the research results.³

If another person contracts with the Company to have the Company perform qualified research, the research will not qualify as research performed by the Company for the purpose of determining the Company's status as a QHTB if the above requirements have been met in favor of the other person, even if the other person is not a QHTB.

The Department has also released Tax Information Release 2008-07 (High Tech Comfort Rulings Relying Upon the Gross Income Test), which is incorporated by reference herein.

A. The Company's presence in Hawaii

The Company maintains its office and facilities in Hawaii. The Company's working members, employees and independent contractors are primarily Hawaii residents.

B. The Company's qualified research activities

The term "qualified research" means:⁴

- (1) The same as in § 41(d), Internal Revenue Code ("IRC");
- (2) The development and design of certain computer software;
- (3) Biotechnology;
- (4) Performing arts products;
- (5) Sensor and optic technologies;
- (6) Ocean sciences;
- (7) Astronomy; or
- (8) Nonfossil fuel energy-related technology.

³ If the Company receives a license, the term of the license must be for the useful life of product(s) or research.

⁴ Section 235-110.9, HRS, incorporates the definition of "qualified research" in § 235-7.3, HRS.

Letter Ruling No. 2009-10

[redacted text]

December 11, 2009

Page 6

Item (1) The same as in § 41(d), IRC

Item (1) of the definition of qualified research above is drawn from IRC § 41(d), where it is defined as research undertaken to discover information technological in nature, which constitutes a process of experimentation relating to a new or improved function, performance, reliability, or quality.

“Qualified research” activities must satisfy the following tests under Treasury Regulation § 1.41-4:

- (a) The expenditures must qualify as research and experimental expenditures under IRC § 174;
- (b) The expenditures must relate to research undertaken to discover information that is both technological in nature and the application of which is intended to be useful in developing a new or improved business component of the taxpayer;⁵ and
- (c) Substantially all of the activities of the research must constitute elements of a process of experimentation that relates to a new or improved function, performance, reliability or quality.⁶

Section 41(d), IRC, further clarifies that qualified research does not include any research:

⁵ Current Treasury Regulation § 1.41-4(a), defines the term "discovering information" to mean research "undertaken for the purpose of discovering information which is technological in nature." For purposes of section 41(d), IRC, information is technological in nature "if the process of experimentation used to discover such information fundamentally relies on principles of the physical or biological sciences, engineering, or computer science." The issuance of a patent by the Patent and Trademark Office under the provisions of section 151 of title 35, United States Code (other than a patent issued under § 171 of Title 35, United States Code) constitutes conclusive evidence that the "discovering information" test has been met.

⁶ Current Treasury Regulations further define a "process of experimentation" as "a process designed to evaluate one or more alternatives to achieve a result where the capability or method of achieving that result, or the appropriate design of that result, is uncertain as of the beginning of the taxpayer's research activities. A process of experimentation must fundamentally rely on the principles of the physical or biological sciences, engineering, or computer science and involves the identification of uncertainty concerning the development or improvement of a business component, the identification of one or more alternatives intended to eliminate that uncertainty, and the identification and the conduct of a process of evaluating the alternatives (through, for example, modeling, simulation, or a systematic trial and error methodology). A process of experimentation must be an evaluative process and generally should be capable of evaluating more than one alternative. The *substantially all* requirement is satisfied only if 80% or more of the research activities measured in cost or other consistently applied reasonable basis constitutes elements in a process of experimentation.

Letter Ruling No. 2009-10

[redacted text]

December 11, 2009

Page 7

1. After commercial production;
2. Related to the adaptation of existing business components;
3. Related to the reproduction of existing business components;
4. Surveys, studies, market research, etc.;
5. Conducted outside of the United States;
6. In the social sciences, arts, or humanities; or
7. To the extent funded by any grant, contract, or otherwise by another person (or governmental entity).

Hawaii's law conforms to the federal definition of "qualified research" as set forth in § 41(d), IRC, and the accompanying Treasury Regulations. Thus, the Company's activities must meet the federal standards of "qualified research" to be classified as such under Hawaii law.

If some of the work is funded by grant, contract, or otherwise by another person or governmental entity, to the extent the work is funded, the requirements of item (1) of qualified research are not met unless the Company retains substantial rights to their research, as defined in § 1.41-4A(d)(2), Treasury Regs., and the funding is contingent upon the success of the research. § 1.41-4A(d)(1), Treasury Regs.

In Part I of the Questionnaire, the Company checked the box indicating that it performs research as defined in § 41(d), IRC. By checking this box, the Company represents it performs research as defined in § 41(d), IRC, and specifically represents the following:

- The Company is developing or improving a business component;
- The Company is employing an evaluative process designed to eliminate uncertainty concerning a new or improved function, the performance, the reliability, or the quality of that business component;
- The Company's research activities regarding that business component fundamentally rely on principles of the physical or biological sciences, engineering, or computer science;
- The Company is not in commercial production; is not adapting or reproducing existing business components; and is not performing surveys or market research;
- The Company's work is not in the social sciences, arts, or humanities; and
- The Company's research activities are not funded by or through any grant, contract, or otherwise by another person or governmental entity; and
- The Company's research activities do not include any activities specifically excluded from the definition of "qualified research" by § 41(d)(4), IRC.

Based solely on the Representations, the Company performs qualified research as defined in §41(d), IRC.

Letter Ruling No. 2009-10

[redacted text]

December 11, 2009

Page 8

Specifically, the Company will further develop and improve the [redacted text] System using [redacted text] technologies and measure the physiological effects on the human body through biological testing and clinical trials. The Company has applied for a United States Patent for the [redacted text] System technology.

Item (3) Biotechnology

Item (3) of the definition of "qualified research" includes biotechnology. Biotechnology is defined in § 235-1, HRS, as the "fundamental knowledge regarding the function of biological systems from the macro level to the molecular and subatomic levels that has application to development including the development of novel products, services, technologies, and subtechnologies from insights gained from research advances that add to that body of fundamental knowledge."

In Part I of the Questionnaire, the Company checked the box indicating that it is involved in biotechnology. By checking this box, the Company represents that it meets the requirements of item (3) of qualified research. The Company represents that it will further develop and improve the [redacted text] System using [redacted text] technologies, all of which impact biotechnology as it relates to the human body.

The Company represents that its ultimate product/technology will be a device/apparatus that requires the Company to undertake substantial biological research in connection with the development of its technology, and knowledge gained from such research adds to the body of fundamental knowledge regarding the function of biological systems.

For example, the Company will research and analyze biological data from individuals regarding the [redacted text] System's positive effects on biological components of the human body, [redacted text]. Further, the Company plans to seek Food and Drug Administration (FDA) approval and begin clinical trials for the medical application of the [redacted text] System.

Based solely on these representations, the Company performs qualified research pursuant to the requirements of Item (3).

C. Activity Test and Gross Income Test

Under § 235-110.9, HRS, in order for a company performing qualified research to meet the definition of a QHTB, it must be a business employing or owning capital or property, or maintaining an office, in the State of Hawaii. In addition, the company must meet the requirements of either the Activity Test or the Gross Income Test. Under the Activity Test, a company is a QHTB if more than 50% of its total business activities are qualified research and more than 75% of such qualified research is conducted in Hawaii. Under the Gross Income Test, a company is a QHTB if more than 75% of its gross income is derived from qualified research in the form of either (i) products sold from, manufactured in, or produced in Hawaii, or (ii) services performed in Hawaii.

Letter Ruling No. 2009-10

[redacted text]

December 11, 2009

Page 9

Due to the highly fact intensive nature of qualifying as a QHTB under the Gross Income Test, including the uncertainty and ambiguity of: 1) revenue streams associated with qualified research; 2) determining the source of product sales; 3) manufacturing or production quantification; as well as 4) the extent services are performed in the State within the meaning of HRS § 235-110.9(g), the Department will not issue rulings determining whether a business satisfies the Gross Income Test for purposes of qualifying as a QHTB.

The Company represents that it will maintain an office in Hawaii.

The Company represents that it will meet the Activity Test because more than 50% of its activities will be in qualified research and more than 75% of those qualified research activities will be conducted in Hawaii. In making this determination, the Company used a numerator that contained the costs of activities in direct support of qualified research and a denominator that included all costs for all activities.⁷ Furthermore, as to the requirement that 75% of the qualified research activities be conducted in Hawaii, the Company used a numerator that contained all costs incurred in direct support of qualified research activities conducted in Hawaii and a denominator that contained all costs incurred for all qualified research activities. In making these representations about the Activity Test, the Company understands that the following activities do not count as qualified research activities for purposes of this test:

- Activities associated with research that is funded by grants and in which the Company has no substantial risks and rights;
- Activities associated with research being performed by the Company pursuant to a contract in which the contract requirements discussed in Part I, above, have been met in favor of another party to the contract; and
- Activities performed by another business on behalf of the Company where the contract requirements discussed in Part I, above, have not been met in favor of the Company.

Specifically, the Company represents that more than 50% of its activities will focus on the further development of the [redacted text] System technology that requires the Company to undertake substantial biological research in connection with the development of its technology, and knowledge gained from such research adds to the body of fundamental knowledge regarding the function of biological systems.

For example, the Company will research and analyze biological data from individuals regarding the [redacted text] System's positive effects on biological components of the human body, including [redacted text]. Further, the Company plans to seek Food and Drug Administration (FDA) approval and begin clinical trials for the medical application of the [redacted text] System.

⁷ "Business activities" may be measured by the cost of these activities, the time spent on these activities, or another consistently applied reasonable basis. This statement is based upon general principles in the income tax and general excise tax law. Whatever the measure adopted by the taxpayer, the measure must reasonably reflect business realities.

Letter Ruling No. 2009-10

[redacted text]

December 11, 2009

Page 10

Based on the Representations, the Company is a QHTB for purposes of the high technology business investment tax credit because it meets the requirements of items (1) and (3) in the definition of "qualified research," the Company will maintain an office in Hawaii, and the Company satisfies the Activity Test. Solely based on the Representations, investments (as defined in HRS § 235-1) in the Company will qualify for the high technology business investment tax credit.

D. Credit Recapture

Section 235-110.9(d), HRS, provides for recapture of credits that have been claimed by a taxpayer where one of the following three events occurs (recapture event):

- (1) The business no longer qualifies as a QHTB;
- (2) The business or an interest in the business has been sold by the taxpayer investing in the QHTB;
- (3) The taxpayer has withdrawn the taxpayer's investment wholly or partially from the QHTB.

Where recapture is triggered, 10% of the amount of the total tax credit claimed by the selling or withdrawing investor in each of the two taxable years prior to the year in which recapture occurs must be added to such investors' tax liability for the taxable year in which the recapture occurs.

The credit cannot be claimed in the year of a recapture event because investors do not have an investment in a QHTB. If a recapture event occurs, the Company should notify the investors that they are not eligible to claim the credit and that some of the credit claimed in prior years shall be recaptured.

II. Income tax exclusion for royalties and other income from QHTB

Pursuant to § 235-7.3, HRS, an income tax exclusion is available for income received by an individual or a QHTB⁸ as royalties and other income derived from any patents, copyrights, and trade secrets developed and arising out of a QHTB.⁹ The exclusion may be claimed by the individual or QHTB that owns the patents, copyrights, or trade secrets. For purposes of the royalty income exclusion, a QHTB is defined as "a business conducting more than 50% of its activities in qualified research."¹⁰

⁸ If the QHTB receiving the income is treated as a partnership for income tax purposes, then the partners or members of the QHTB may exclude the allocated portion of such income, even if the partner or member excluding the income is not an individual or QHTB.

⁹ Expenses for royalties and other income derived from any patents, copyrights, and trade secrets by an individual or a QHTB as defined in § 235-7.3, HRS, are deductible. See § 235-2.4(g), HRS.

¹⁰ This definition differs from the definition of a QHTB in § 235-110.9, HRS, which is discussed in Part I of this letter.

Letter Ruling No. 2009-10

[redacted text]

December 11, 2009

Page 11

As discussed in Part I, relating to the high technology business investment tax credit, the Company's representations meet the requirements of items (1) and (3) in the definition of "qualified research." The Company also represents that more than 50% of the Company's activities are in qualified research, again using a numerator that contained the costs of qualified research activities and a denominator that included all costs for all activities. Based on the Representations, royalties and other income derived from any patents, copyrights, and trade secrets developed and arising out of the Company received by an individual¹¹ or a QHTB may be excluded from income tax. Furthermore, as long as the Company is a QHTB for purposes of § 235-7.3, HRS and treated as a partnership for income tax purposes, each member's allocated portion of royalties and other income derived from patents, copyrights, and trade secrets owned by the Company and developed and arising out of a QHTB may be excluded from income tax by the members of the Company.

III. Income tax exclusion for stock options from qualified high technology business

Section 235-9.5, HRS, provides an exclusion for "all income earned and proceeds derived from stock options or stock," including stock issued through the exercise of stock options or warrants, from a QHTB or from a holding company of a QHTB¹² by an employee, officer, or director of the QHTB, or investor who qualifies for the high technology business investment tax credit in § 235-110.9, HRS, effective for taxable years beginning after December 31, 2000. This exclusion is applicable to dividends from stock or stock received through the exercise of stock options or warrants, the receipt or the exercise of stock options or warrants, and income from the sale of stock, including stock issued through the exercise of stock options or warrants.¹³

With respect to a partnership or a limited liability company treated as a partnership for income tax purposes, the exclusion is applicable only to the gain from the sale of membership interest units. For purposes of this income tax exclusion, a QHTB means the same as defined in §235-7.3, HRS, relating to the income tax exclusion for royalties.

As discussed in Part I, relating to the high technology business investment tax credit, the Company's representations meet the requirements of items (1) and (3) in the definition of

¹¹ The performing arts product exclusion in § 235-7.3, HRS, is applicable to the author and assignors, licensors, and licensees.

¹² A holding company of a QHTB means any business entity that possesses:

- (1) At least eighty per cent of the total voting power of the stock or other interest; and
- (2) At least eighty per cent of the total value of the stock or other interest in the qualified high technology business.

¹³ Section 165, IRC, is operative for Hawaii income tax purposes and applies to losses sustained from the sale of stock issued through stock options or warrants granted by a QHTB. See § 235-2.4(d), HRS.

Letter Ruling No. 2009-10

[redacted text]

December 11, 2009

Page 12

"qualified research." The Company also represents that more than 50% of the Company's activities are in qualified research, again using a numerator that contained the costs of qualified research activities and a denominator that included all costs for all activities. Based on the Representations and assuming the Company is treated as a corporation for income tax purposes, the income earned and proceeds derived from stock options, stock, options to acquire an equity interest, or equity interests may be excluded from income tax. However, if the Company is treated as a partnership for income tax purposes, only the gain from the sale of membership interest units may be excluded from income tax. And if the Company is treated as a sole proprietorship because it is a single-member limited liability company, then § 235-9.5, HRS, is not applicable.

IV. Conclusion

Based solely on the Representations, the Company qualifies for:

1. The high technology business investment tax credit under §235-110.9, HRS, subject to any changes mandated by Act 178;
2. The income tax exclusion for royalties and other income derived from patents, copyrights, and trade secrets received by an individual or a QHTB and developed and arising out of a QHTB under §235-7.3, HRS; and
3. If the Company is taxed as a corporation, the income tax exclusion for income earned and proceeds derived from stock options or stock, including income from dividends from stock or stock received through the exercise of stock options or warrants, the receipt or exercise of stock options or warrants, and the sale of stock options or stock, including stock issued through the exercise of stock options or warrants, under §235-9.5, HRS is applicable. If the Company is treated as a partnership for income tax purposes, the section 235-9.5, HRS exclusion is applicable only to the gain from the sale of membership units.

This ruling is applicable only to the Company and shall not be applied retroactively. It may not be used or cited as precedent by any other taxpayer, and is based on our understanding of the facts that you have represented and only apply if the amount of cash investments received by the Company does not exceed \$ 500,000. In the event that the Company finds it necessary to increase the amount of investment monies to be obtained which qualifies for the high technology business investment tax credit, the Company shall submit a supplemental ruling request to the Department. No user fee shall be assessed on such supplemental ruling request. If it is later determined that our understanding of these facts is not correct, the facts are incomplete, or the facts later change in any material respect, the conclusion in this letter will be modified accordingly. This ruling also may be subject to change due to future amendments to laws, rules, or official Department positions.

Letter Ruling No. 2009-10

[redacted text]

December 11, 2009

Page 13

If you have any further questions regarding this matter, please call me at 808-587-5334. Additional information on Hawaii's taxes is available at the Department's website at <http://www.hawaii.gov/tax>.

Sincerely,

/s/ Jacob L. Herlitz

Jacob L. Herlitz
Administrative Rules Specialist

[Exhibits A and B redacted]